Macroeconomics in the conservative era

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Abstract:
Macroeconomic Policy After the Conservative Era: Studies in Investment, Saving, and Finance, edited by Gerald A. Epstein and Herbert M. Gintis, is reviewed.

Full Text:

In a review of a new book on liberal macroeconomic policies, Nobel laureate James Tobin assesses new ideas about how to manage the economy that, he thinks, may provide a "courageous" new beginning for the Left.

Economists are notorious for their disagreements, and macroeconomic theorists disagree most of all. The field of macroeconomics is split into schools, which differ in their theories and consequently in their policy recommendations. These schools, alas, might even be called sects. Here it will suffice to distinguish three. First, the theoretical mainstream in graduate schools and academic journals these days is a reprise of the pre1930 classical orthodoxy that John Maynard Keynes attacked in 1936. Its modern adherents call themselves the New Classicals. Second, the mainstream circa 1960-65 in the United States was a synthesis of Keynes and neo-classical microeconomics. This once-dominant Keynesian tradition still has loyal exponents. Although pushed out of fashion by the New Classicals, it is still the macro-theory of most practical econometric models and most policy analysts in business and government. Third, to the left of the other two schools are the self-styled Post-Keynesians, inspired by some of Keynes's associates (notably Joan Robinson, Michael Kalecki, and Nicholas Kaldor), who stressed the more radical implications of Keynes's critiques of capitalism and classical economics.

A new book, Macroeconomic Policy After the Conservative Era: Studies in Investment, Saving, and Finance (eds. Gerald A. Epstein and Herbert M. Gintis [Cambridge, UK: Cambridge University Press, 1995]) is a compilation of pieces that largely exemplify the ideas of the third school with a few ideas from the second, and the publication presents an opportunity to review the arguments on all sides.

The issues of theory and policy on which these schools disagree can be discussed under four headings: the determination of aggregate output and employment, monetary phenomena and policies, fiscal policy, and the distribution of income and wealth.

The Determination of Aggregate Output and Employment

The roles of aggregate demand and aggregate supply underlie most disagreements over macro-policies. What constrains the economy's output? Classical economists, old and new, say that output is constrained by limitations on capacity to produce, shortages of labor, plant and equipment, land and other natural resources, and technology. Their modern "real business cycle" model sees supply as the constraint both in short-run cyclical fluctuations and in long-run growth. Keynes's revolution argued that capitalist economies suffered most often from insufficient aggregate demand. Involuntary unemployment is the most visible symptom of economy-wide excess supply If consumers, businesses, and governments chose to spend more, the economy could and would respond by producing more. As the PostKeynesians interpret the matter, this is true almost always, in short-run business cycles and secular trends alike.

Thus, the New Classicals and Post-Keynesians have one point of similarity: The same model applies to short-run fluctuations and to long-run trends. They are at opposite poles, however, on what that model is. Keynesians, on the other hand, subscribe to a two-regime model. In the long run, over decades, the economy tracks the growth of capacity; this is the classical supply-constrained regime. In Robert Solow's neo-classical growth model, exogenous labor supply, capital accumulation, and technology interact to determine the trend of output, whose rate of growth mirrors that of labor supply plus technology But in the short run the economy is constrained by demand, as mainstream Keynesians and Post-Keynesians agree.

In Chapter Four of Macroeconomic Policy After the Conservative Era, Robert Eisner, an older-generation Keynesian who dissents from his mainstream friends, challenges the view that the economy is constrained by a capacity barrier indicated by a nonaccelerating inflation rate of unemployment (NAIRU), which below inflation rises continuously. Eisner finds that statistically unemployment and inflation are related positively, not inversely as orthodox Keynesians assume. However, this is quite likely an artifice of the supply shocks of the 1970s, notably the rise in the oil price, which dominate the data of that period.

Somewhere, there must be a capacity barrier to expanding output by demand stimuli, and very likely one of its symptoms would be inflation. But this might occur at an unemployment rate far below conventional NAIRU estimates (between 5.5 and 6 percent). Anyway, modest inflation or restrictions on wage and price increases might be small prices to pay for high output and employment. This is the Post-Keynesian sermon that William Vickrey was preaching from his Nobel rostrum until he died three days after it was announced that he had won the prize.

Monetary Phenomena and Policies

The three schools differ sharply in their views of money and monetary policy The traditional and modern classical position is that money is neutral, a "veil" that may obscure vision of the real economic world but does not alter it. Precisely because people with their well-being at stake do see through the veil, money is powerless to affect the economic outcomes that matter-that is, central banks cannot affect real interest rates, aggregate output and employment, real wages, or any other non-monetary outcomes, so the argument goes. Central bankers can only determine nominal prices and inflation, but these are not of any real consequence. Central bankers and other financiers welcome the doctrine that they are not responsible for unemployment and real GDP, although they propose that the conquest of inflation is essential for prosperity and progress.

Keynesians agree that when the economy is supply constrained, money cannot alter employment or GDP and is therefore roughly neutral in long runs. But in short-run business cycles, monetary events and policies are crucial determinants of aggregate demand and macroeconomic performance. These days, monetary policy is perhaps the most powerful instrument of stabilization.

Post-Keynesians, however, are skeptical for one or more of the following reasons: Interest rates cannot be pushed low enough to counter recession and deflation effectively, and to return the economy to full employment.l The Federal Reserve is too conservative and anyway could be overruled by private financial markets-the notorious Bond Market-if their policies were viewed as unsound and inflationary. Many PostKeynesians also argue that money supplies are endogenous, outside the control of the central bank, contrary to the assumptions of the Keynesians.

Fiscal Policy

The disagreements about fiscal policy are corollaries of the two foregoing positions. There are two conservative positions. Some New Classicals subscribe to the so-called Barro-Ricardo equivalence theorem, which argues that government saving and dissaving are offset by rational taxpayers, who know that deficits now portend taxes later. In this conservative variant, borrowing is not really different from taxing, and deficit spending is both impotent and innocuous, in macroeconomic terms. (Microeconomically, government use of resources is likely to be wasteful.) More traditional conservatives see government deficits as raising interest rates, pre-empting private saving, and crowding out productive private investment.

Keynesians have the same worry, but only when the economy is in its supply-constrained regime. In the demand-constrained regime, deficits need not crowd out anything but will have positive effects on output and employment, and quite possibly on investment and saving, too. At the same time, American Keynesians may welcome fiscal constraint if they are confident that its negative demand effects will be offset, as they can be, by expansionary monetary policy. The fruits of such a policy mix would be to substitute investment for consumption and raise productivity in the long run.

Post-Keynesians, skeptical of monetary policy, would not endorse that policy package. They would count on the macro-consequences of expansionary fiscal measures to generate investment for the future. David Gordon (whose tragic death in 1996 deprived the world of an original mind and PostKeynesians of a creative leader) argued this case persuasively in Chapter Three, and Eisner concurs in Chapter Four. Gordon deploys high-powered econometrics to assert that, contrary to the standard view of Classicals and Keynesians, investment causes saving, but saving does not cause investment. This might appear to be true in statistical relationships if no attempt were made to control for regime, whether demand or supply constrained. For example, investment and saving both grew as the U.S. economy recovered in the 1980s, but the recovery as a whole was characterized by abnormally high interest rates and low investment, compared to recoveries with lower government deficits and higher national saving ratios.

The Distribution of Income and Wealth

New Classicals and Keynesians share credence in the classical marginal productivity theory of the distribution of income among wages, profits, and rents. The founders of Post-Keynesian theory parted with Keynes himself on this point. Their tradition lives on in Cambridge, England, and elsewhere in their school today Seeking an alternative theory of income distribution, they stress causation running from investment to profits. Investment brings forth saving to match, not by expansion of income in general but of capital income in particular. This type of model was a component in the work of the late Hyman Minsky, whose PostKeynesian business-cycle theory is developed in interesting ways by Peter Skott in Chapter Nine. But there is little sign of the investment-causes-profits tradition in this volume. There are indeed three good conventional empirical studies of investment as an effect of national income and profits and other causes.

A related Post-Keynesian deviation from mainstream Keynesian macro-theory has been "wage-led growth," the view that increases in wage rates would stimulate demand and therefore employment, a proposition naturally favored by the union movement. This receives little emphasis here. Indeed, the conclusions of Samuel Bowles and Robert Boyer in Chapter Five are mainly negative.

The aspiration of Macroeconomic Policy After the Conservative Era is a new overall model of economies, national and worldwide, supporting a new set of policy prescriptions for growth in living standards, fair distribution of income and wealth, and conservation of human and environmental capital. To set the stage, Andrew Glyn (Chapter Two) recounts the failures of the advanced capitalist countries in the 1980s-accurately in my viewincluding lagging productivity, rising inequality of income, and high unemployment.

The final three chapters are dedicated to proposals to replace "the conservative era" of doctrine and policy with "new rules of the game." Chapter Twelve is a formal macro-model built by David Gordon, incorporating structural reforms to pave the way for policies to achieve full employment and growth while reducing inequality. In Chapter Fourteen, Bowles and Gintis seek to break the dismal trade-off between efficiency and equality by "productivity-enhancing asset redistributions."

Between them, in Chapter Thirteen by Epstein and Gintis, is the most novel and interesting contribution of the book. Epstein and Gintis sketch a political-economic structure, involving policy rules enforced by rewards and penalties on politicians and bureaucrats, and similar rules and sanctions for managers of capitalist enterprises. Taking seriously the cynical view of democracy expressed in public-choice theory, as well as New Classical critiques of discretionary policy-making, the authors disavow the Scandinavian social-democratic (American-liberal) model of government, as naively dependent on high-minded statesmen.

Epstein and Gintis stress the increasing necessity for government initiatives to build human capital; protect and improve the environment; supply infrastructure for transportation, communication, science, and culture; curb concentration of economic power; organize social insurance; and limit inequality of wealth and income. These governmental responsibilities, they argue, are essential to overcome the centrifugal forces inherent in individualistic market capitalism. They are essential to sustain the sense of community and trust necessary to make our complex interdependent societies work, and without them the burden of law enforcement overwhelms police and courts.

Enthusiasts for the Invisible Hand regard free-market capitalism with minimal government and low taxes as a perpetual motion machine, a self-sustaining structure that generates endless progress. In explaining growth, they disdain mechanistic calculus of saving, investment, and demographics and ignore the law of diminishing returns. They rely on social psychology, sociology, and political science, as well as economics, and dismiss as irrelevant the contesting schools of macroeconomics reviewed above. The final chapters of this book sketch an alternative self-sustaining structure, designed to perform for the Left the same intellectual function as the Invisible Hand performs for the Right. That would give new meaning to the term "post-Keynesian." At least Epstein, Gintis, and company have made a courageous and plausible beginning.

Note

1. Keynes himself stated in The General Theory that interest rates might hit an irreducible floor in depressions, even with central banks aggressively supplying money But he regarded this "liquidity trap" as abnormal. Nevertheless, it was an important reason why many of his disciples put no faith in monetary policy After World War II and especially in the American synthesis of Keynesian and neo-classical theories, the equation of Keynesianism with "fiscalism" abated. Recently, Japan demonstrated that incredibly bad macro-management can bring the liquidity trap back to life.

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